



# Supervisory Letter



## Supervising Low Income Credit Unions and Community Development Credit Unions

### Introduction

The purpose of this document is to provide examiners guidance on issues they might face when supervising low income credit unions (LICUs) and self-designated community development credit unions (CDCUs). The guidance discusses the characteristics, benefits, and unique challenges of these types of credit unions and includes an appendix describing resources available to them. Examiners should remember, however, all federal credit unions have a continuing obligation to meet the financial service needs of people of modest means.<sup>1</sup> Therefore, most of this guidance will apply to most credit unions.

In 2005, NCUA issued a Letter to Credit Unions (LCU), entitled *Supervising Community Development Credit Unions*, LCU 05-CU-01 (February 2005). That letter included a white paper designed to facilitate examiners' understanding and ability to supervise the unique challenges faced by LICUs and CDCUs.

### Low Income Credit Unions (LICUs)

In 1970, the Federal Credit Union Act was amended to authorize the NCUA Board to define "low income members" to permit credit unions predominantly serving them to take advantage of certain statutory benefits. The low-income designation criteria were amended in 2008 to use median family income or median earnings for individuals to determine if a credit union qualifies for a low-income designation and potential assistance through loans and grants from NCUA's Community Development Revolving Loan Fund (CDRLF). This amendment also helped better align the low-income designation criteria with the criteria for adding an underserved area to a federal credit union's field of membership. Adding an underserved area does not automatically qualify a credit union for the NCUA low-income designation.

All federally-insured credit unions may receive a low-income designation if they meet the qualifications.<sup>2</sup> Effective January 1, 2009, members qualify as low-income based on either median family income or median earnings for individuals, whichever is more beneficial to determining if the credit union qualifies for the designation.<sup>3</sup> Federally-

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<sup>1</sup> State credit union laws reference provision of thrift and financial services to their members rather than serving people of modest means.

<sup>2</sup> 12 C.F.R. §§ 701.34, 741.204.

<sup>3</sup> 12 C.F.R. § 701.34(a)(2).

insured credit unions serving a membership that consists of a majority of low income members qualify for the low-income designation.

With the low-income designation, credit unions gain access to additional sources of funding and resources, from both NCUA and outside parties.<sup>4</sup> Some additional sources of funding include:

- Nonmember deposits, 12 C.F.R. § 701.32;
- Secondary capital, 12 C.F.R. § 701.34;
- Loans and technical assistance grants under Community Development Revolving Loan Program, 12 C.F.R. Part 705; and,
- The United States Department of Treasury's Community Development Financial Institutions (CDFI) Fund.

LICUs are also eligible for an exception to the aggregate loan limit on member business loans.<sup>5</sup> Additionally, a credit union that qualifies for a RegFlex designation is exempted from the limits on nonmember deposits.<sup>6</sup>

Refer to the appendix "*Resources for Low Income Credit Unions*" for additional information.

### **Community Development Credit Unions (CDCUs)**

NCUA does not designate or charter CDCUs. The term "CDCU" is not a term used in the Federal Credit Union Act or NCUA's regulations. Credit unions using the term CDCU generally define themselves as credit unions dedicated to serving and revitalizing low-income communities. NCUA understands CDCUs predominately serve people of modest means and are committed to serving their members as well as the economic and development needs of the broader community. Self-designated CDCUs may be federally or state-chartered and can have a community, associational, occupational, or multiple common bond field of membership.

### **Characteristics of LICUs, CDCUs and the Members They Serve**

LICUs and, generally, CDCUs typically serve a membership primarily composed of low income members. These credit unions face unique challenges serving members. The challenges are even more prevalent in small credit unions. Their members may face one or more of the following circumstances and characteristics:

- Unsteady employment (often temporary jobs with long hours);
- Part-time employment with multiple jobs or side businesses;
- Unstable residency (often rent or live in public or subsidized housing);
- No health insurance;
- Lack of affordable child care;
- Receive supplemental security income or social security disability benefits;
- English as a second language;
- Low share account balances;

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<sup>4</sup> Federally insured state credit unions may have different sources pursuant to state law.

<sup>5</sup> 12 C.F.R. §§ 723.17 and 723.18.

<sup>6</sup> 12 C.F.R. §742.4(a)(2).

- Need for small dollar loans;
- Limited financial resources;
- Limited, negative, or no credit history; and,
- A need for labor-intensive services (e.g. money orders, financial education and/or counseling, check cashing).

Examiners should consider these member characteristics and take them into account when they evaluate LICU loan portfolios as well as the products and services these credit unions offer.

### **Characteristics of a Well-Managed LICU or CDCU**

Characteristics of a well-managed LICU or CDCU will include most of the following:

- Maintains sound internal controls;
- Develops, follows, and adjusts comprehensive strategic, business and budget plans to meet the credit union's and members' needs;
- Retains skilled and dedicated staff because servicing members is a top priority;
- Maintains up to date, accurate records;
- Implements financial education and counseling, as applicable, for members as part of the lending process;
- Identifies and documents compensating factors supporting the loan decision, especially when income verification is difficult or credit history is limited, negative, or non-existent; and,
- Communicates regularly with membership.

In evaluating these credit unions, examiners should assure that the credit union's risk management efforts are commensurate with the size and complexity of the institution. Moreover, examiners should use appropriate or customized peer categories (e.g., other LICUs or CDCUs of similar asset size and complexity) to measure a credit union's risk management efforts.

### **Strategic Risk**

Strategic risk is the current and prospective risk to earnings or capital arising from adverse business decisions made, improper implementation of decisions, or lack of responsiveness to industry changes. As in all credit unions, LICUs and CDCUs should carefully consider strategic risk when making decisions regarding the credit union's operations. In order to mitigate high strategic risk, the credit union should:

- Ensure risk exposure reflects strategic goals established by management;
- Develop, maintain, and adapt (as circumstances change) a business plan that directs the operation and is commensurate to the size and complexity of the credit union;
- Define acceptable levels of risk in different areas of operation that are compatible with business plan strategies;
- Develop quantitative measures to help assess progress with business plan goals;
- Adjust operations to address new circumstances, such as changing economic environment or changes to members' needs; and,
- Establish and maintain sound parameters for new member services.

LICUs and CDCUs should consider all ramifications of business decisions when starting a new program or service or adjusting a program or service already in place. When credit unions make these types of changes to operations, it is critical for credit union management to perform a thorough due diligence review. When beginning new programs, management should establish their limits, especially in regards to financial abilities and staffing needs. Once these limits are defined, management should work to stay within those boundaries to ensure risks remain within acceptable levels. New programs should have short-term, interim targets to allow credit unions to evaluate their processes and controls before reaching the limits established by the board. Examiners should evaluate management's plans to ensure the credit union has a guide to operating a financially sound institution that is meeting the realistic strategic and capital goals of the board of directors and will meet the needs of the membership.

### **Credit Risk**

Credit risk is the risk of default on expected payments of loans or investments. LICUs and CDCUs may have a higher concentration of loans made to people with lower credit scores. This often increases the credit risk at the credit union. It is necessary for the credit union to manage the additional risk at a sound level for both the member and the credit union over the long term, while maintaining an acceptable level of strategic risk commensurate with the credit union's business plan. Strategies for managing this risk should be well documented in the policies, procedures, and strategic plan.

LICUs and CDCUs generally make credit available to their members by offering non-traditional lending products. These credit unions adapt their operations to fit the unique needs of their membership. Non-traditional products, procedures, and services that some credit unions use to better serve low income members include:

- Non-traditional loan underwriting, such as:
  - Explaining limited, negative, or no credit history;
  - Requiring payroll deduction for loan payments;
  - Documenting history of making timely rent and utility payments; and,
  - Using a qualified co-signor who sufficiently offsets credit risk;
- Loan restructuring; and,
- Financial literacy programs.

When offering non-traditional lending products, it is essential credit unions maintain strong collection programs to mitigate increased credit risk. A strong collection program should be in place before the credit union begins to make loans with a higher risk. A strong collection program should include:

- Firm and fair collection officer;
- Accurate, timely delinquency reports;
- Written collection policy that specifically outlines when the credit union will make contacts and by what means (e.g. telephone, postal mail, email, etc.);
- Quick reaction to first missed payment (contact should be made within one week);
- Quick reaction to missed promises to pay by delinquent members;

- Documenting, repeated contacts with delinquent members;
- Collateral liquidation procedures; and,
- Procedures for loan restructuring once a member begins making regularly scheduled payments.

Even though LICUs and CDCUs often offer higher risk loan products, maintaining credit risk within an acceptable level while meeting the needs of the members is still crucial to the operation of the credit union. Effective intervention by the credit union before the member falls further behind in his/her payment can serve to prevent the member from being placed in an increasingly worse financial position.

## **Financial Analysis**

When reviewing the financial statements of a LICU, examiners must consider the effects the different types of funding available to LICUs may have on their balance sheets. Funding sources such as nonmember deposits, secondary capital, and loans from the CDRLF will affect the financial ratios of these usually small credit unions.<sup>7</sup> In addition to the effects of the additional funding, examiners must also consider the unique characteristics of members in LICUs and CDCUs.

Moreover, examiners should recognize that LICUs and CDCUs systematically show higher operating costs than other credit unions because of the nature of the field of membership they serve. Similarly, delinquency rates at LICUs and CDCUs, while often higher than other credit unions, do not automatically translate proportionally into charge-offs.

Examiners need to look beyond the financial ratios to analyze the credit union's financial condition accurately. The following table includes examples of items to consider when analyzing the financial condition of a LICU or CDCU.

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<sup>7</sup> See appendix "*Resources for Low-Income Designated Credit Unions*" for additional information.

Financial Ratio Trends	Items to Consider
↑ In Delinquent Loans / Total Loans	<ul style="list-style-type: none"> <li>▪ Is the credit union's charge-off history increasing or remaining stable?</li> <li>▪ Analyze individual loan histories – does the borrower miss more than three payments in a year?</li> <li>▪ How often does the credit union communicate with delinquent borrowers? Is a strong collection policy being followed?</li> <li>▪ Could local economic reasons be a cause for the rise in delinquency?</li> <li>▪ Is the loan's principal balance reducing?</li> </ul>
↓ In Return on Average Assets (ROAA)	<ul style="list-style-type: none"> <li>▪ For LICUs, is there an increase in nonmember deposits, secondary capital, or loans from the CDRLF that increased average assets while earnings remained stable?</li> <li>▪ Is loan growth outpacing growth in income?</li> <li>▪ Is there an increase in expenses from new services offered?</li> </ul>
↑ Operating Expenses / Gross Income	<ul style="list-style-type: none"> <li>▪ Is there a program funded with grant money that causes the expenses to appear high, but is offset with income from the grant?</li> <li>▪ If expenses associated with a grant-funded program were backed out, would the ratio appear more reasonable?</li> <li>▪ Is the credit union eligible for grant funding that could offset the increase in operating expenses in the short-term?</li> <li>▪ Is the credit union's fee structure appropriate to offset the expenses of labor intensive services (e.g. share draft or check cashing)?</li> </ul>

It is important that examiners view LICUs and CDCUs against their low-income and CDCU peers, rather than simply comparing them to other credit unions of similar asset size, which may benefit from such things as payroll deduction or higher-income members. Peer ratio data in AIREs and on the credit union's financial performance report (FPR) are not specific to LICUs. To understand the financial ratios of LICUs better, examiners can and should customize an FPR to include only LICUs of similar asset size on NCUA's internet site at <http://webapps.ncua.gov/ncuaafpr/>.

Some of the differences between LICUs and credit unions that are not low-income designated are illustrated in the following table. The table compares trends between two credit unions located in the same city with assets of approximately \$40 million and explains obstacles the LICU must address.

Low-Income Designated Credit Union Trend	Non Low-Income Designated Credit Union Trend	Items to Consider
Grants 1,620 loans during quarter	Grants 327 loans during quarter	<p>Even though the LICU granted four times as many loans as the non LICU, the average loan balance was greater on the 327 loans than the 1,620. This high volume of loans for the LICU is:</p> <ul style="list-style-type: none"> <li>▪ More labor intensive (i.e. time spent processing, time spent answering member questions);</li> <li>▪ More costly (i.e. requires more supplies to process); and,</li> <li>▪ More collection efforts due to number of members slow to pay (i.e. requires more collectors, delinquency notices, postage).</li> </ul>
Maintains 4,628 share draft accounts	Maintains 2,959 share draft accounts	<p>Even though the LICU has more share draft accounts than the non LICU, the non LICU has approximately \$2 million more in total share drafts. The low balance share draft accounts for the LICU are:</p> <ul style="list-style-type: none"> <li>▪ More labor intensive (i.e. volume of transactions translates to more staff needed and more financial education); and,</li> <li>▪ More costly (i.e. more supplies and equipment needed).</li> </ul>

Examiners should recognize factors such as those discussed in this section when reviewing the financial condition of LICUs and CDCUs. The recognition of these factors will provide the examiner a better understanding of how and why the credit union operates as it does. This comprehensive understanding of the LICU and CDCU structure will allow examiners to appropriately assign CAMEL ratings based on risk to the National Credit Union Share Insurance Fund (NCUSIF) and not unduly lower the rating based solely on the LICU and CDCU business model.

### **Preserving LICUs and CDCUs**

Examiners should work with LICUs and CDCUs to help them compete in their financial market. Within the constraints of regulations and safety and soundness, LICUs and CDCUs with the ability to succeed should be given the time and flexibility necessary to succeed. An examiner working with management and understanding the unique characteristics of these types of credit unions should afford them an opportunity to survive. In addition, the factors below should be considered in order to preserve LICUs and CDCUs.

### *Mentoring*

Examiners should work with their supervisors to survey larger credit unions that may be interested in assisting LICUs and CDCUs. Many larger credit unions are often interested in assisting smaller credit unions with risk management or operational tasks. Larger credit unions can often provide office space, recordkeeping assistance, and collections assistance.

### *Supervising New Charters and Existing Charters*

NCUA offers the assistance of Economic Development Specialists (EDSs), who are specialized examiners in NCUA's Office of Small Credit Union Initiatives, to newly chartered and existing credit unions. EDSs have expertise regarding small credit unions and can provide LICUs and CDCUs with needed guidance, such as "best practice" suggestions from other LICUs or CDCUs. These specialized examiners can also provide information and answer questions regarding the variety of potential funding sources available to LICUs and CDCUs.

In addition, NCUA offers the Small Credit Union Program (SCUP) to all credit unions with assets less than \$10 million. This program is made up of SCUP examiners who are available to provide assistance to small credit unions on a regional level such as that provided by the EDS program on a national level.

### *Mergers*

After considering all viable options, struggling LICUs and CDCUs sometimes merge into financially stronger credit unions. To ensure the merging credit union's members continue to receive services and efforts to serve people of modest means, NCUA and credit union officials should consider the possibility of merging with another LICU or CDCU. NCUA must merge any financially unsound credit union at the lowest cost to the National Credit Union Share Insurance Fund.<sup>8</sup> However, NCUA will take into consideration the best interests of the merging credit union's members when deliberating on potential merger partners.

## **Conclusions**

There are some unique challenges to supervising and examining LICUs and CDCUs, but these credit unions face the same risks as other credit unions and must maintain safe and sound operations. As described in this supervisory letter, NCUA must provide appropriate oversight of higher risks that LICUs and CDCUs might pose to ensure all credit unions have the financial strength to continue serving people of modest means.

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<sup>8</sup> See, 12 U.S.C. 1788.



## **Appendix Resources for Low Income Credit Unions (LICUs)**

Examiners should understand and make their LICUs aware of the available opportunities and resources. The information below outlines some opportunities and resources available for LICUs. For more detailed information, go to NCUA's Resource Connection located at <http://www.ncua.gov/Resources/CreditUnionDevelopment/ResourceConnection/index.aspx>.

### **Nonmember Deposits**

LICUs may accept nonmember deposits from any source as stipulated in NCUA regulations.<sup>9</sup> Many different types of organizations, such as other financial institutions, will often consider making nonmember deposits in LICUs. With appropriate strategic, business, and budget planning and management, these funds can provide a fiscally sound source of funding for these credit unions.

Nonmember deposits may have interest rates at or below market rates allowing the opportunity for providing services on well thought out and financially sound programs. Some examples of programs credit unions have started with funds from nonmember deposits include: funding new loan programs, covering costs associated with establishing new member services, and adding employees to provide financial counseling for members. When considering whether to seek or accept nonmember deposits, credit unions should take into account the full ramifications the deposits will have on the financial safety and soundness of the credit union. Nonmember deposits may be a relatively expensive source of funds that can negatively affect earnings. Management should consider such questions as:

- How will the credit union use the funds made available with the nonmember deposit?
- What is the financial impact of the nonmember deposit to the credit union's net worth?
- Are there other or future benefits the credit union will receive because of the relationship with the organization providing the nonmember deposit?
- Does the credit union have a liquidity plan to repay the funds?
- Can a net positive return be achieved on the fund? Is the income generated on the additional funds greater than the dividend cost paid to have the funds on deposit?

In computing the cost-benefit of nonmember deposits, examiners should be cognizant of several factors:

- Servicing a single large deposit may be considerably less costly than serving a large number of depositors with very small share balances;

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<sup>9</sup> 12 C.F.R. § 701.32.

- Nonmember deposits are often a “relationship” business. Returning nonmember deposits before maturity may jeopardize the relationship of the credit union to a foundation, government, social investor, or other philanthropic source; and,
- Nonmember deposits may lower net worth in the short-term, but additional income earned from the deposits could strengthen long-term net worth.

NCUA regulations limit the amount of public unit and nonmember deposits to the greater of 20 percent of the credit union’s total shares or \$1.5 million.<sup>10</sup> Deposits in excess of this limitation are subject to regional director approval.<sup>11</sup> However, this limitation does not apply to accounts maintained in Treasury Tax and Loan Depositories or Depositories and Financial Agents of the Government,<sup>12</sup> matching funds required by NCUA’s Community Development Revolving Loan Program for credit unions with outstanding loans,<sup>13</sup> and credit unions qualifying for RegFlex.<sup>14</sup>

### Secondary Capital

LICUs should take into account the same financial considerations for secondary capital as discussed with nonmember deposits. LICUs may accept secondary capital in accordance with the requirements in NCUA regulations, 12 C.F.R. § 701.34(b). Before accepting secondary capital, however, the credit union must develop, adopt, and submit a secondary capital plan to the appropriate regional director. The secondary capital plan ensures the credit union has considered the impact the funds will have on its financial performance. The credit union plan should show specific uses for the funds along with including appropriate plans to replace or continue without the funds as the funds mature.<sup>15</sup>

Secondary capital typically serves to increase net worth and allow the credit union to increase lending. Secondary capital accounts have the longest term at most credit unions, and should have a beneficial ALM effect. For example, one possible use of secondary capital could be to implement a new lending program. The credit union should match the loan maturities to the term of the secondary capital account or have another source of funds planned to replace the funds as they mature.

NCUA regulations stipulate specific accounting treatment for secondary capital accounts, and credit unions need to consider the impact to their net worth of depreciating or “writing down” the capital account and adjusting financial operations as needed.

### Community Development Revolving Loan Program

Since 1986, NCUA has administered the Community Development Revolving Loan Fund (CDRLF), funded by Congress. NCUA’s Community Development Revolving Loan Program is described in part 705 of NCUA regulations.<sup>16</sup> The purpose of this program is to:

<sup>10</sup> 12 C.F.R. §701.32(b), 741.204.

<sup>11</sup> 12 C.F.R. § 701.32(b)(2).

<sup>12</sup> 12 C.F.R. § 701.37.

<sup>13</sup> 12 C.F.R. § 705.7(b).

<sup>14</sup> 12 C.F.R. §742.4(a)(2).

<sup>15</sup> 12 C.F.R. §701.34(b)(1).

<sup>16</sup> 12 C.F.R. Part 705.

- Provide basic financial and related services to residents in low-income communities; and,
- Stimulate economic activities in low-income communities, which will result in increased income, ownership, and employment opportunities for low-income residents, and other community growth efforts.

Only LICUs are eligible to participate in the Community Development Revolving Loan Program. These credit unions can receive up to \$300,000 in aggregate loans from the CDRLF. Within one year of receiving the loan, the recipient must match the loan amount with share deposits. Examiners are encouraged to discuss the availability of these funds with their LICUs. Credit unions can also access applications and monthly reports regarding the funds available through this program at <http://www.ncua.gov/Resources/CreditUnionDevelopment/Finance.aspx>.

#### Technical Assistance

In years past, Congress has earmarked \$1 million to be used specifically for technical assistance grants as part of NCUA's Community Development Revolving Loan Program. These cash grants are intended to help LICU officials, management, and staff acquire specialized skills, equipment, or other forms of assistance to improve member services and enhance their credit union's financial strength. In addition to congressional appropriations, interest earned on the CDRLF loans is used to fund technical assistance grants. The average technical assistance grant is under \$5,000. Applications for technical assistance grants are located at <http://www.ncua.gov/Resources/CreditUnionDevelopment/Finance.aspx>.

#### Community Development Financial Institutions Fund

The Riegle Community Development and Regulatory Improvement Act of 1994 established the Community Development Financial Institutions (CDFI) Fund, which is operated by the United States Department of Treasury. The fund expanded the capacity of financial institutions to provide credit, capital, and financial services to underserved populations and communities in the United States. Many LICUs and other credit unions with a demonstrated concentration of members located in investment areas (i.e. underserved areas) as defined by the CDFI can become CDFI certified through the CDFI Fund and be eligible to apply for larger dollar grants and capital funds. Details about certification and funding programs are available at <http://www.cdfifund.gov>.